

**BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION**

**COPY**

**IN THE MATTER OF THE NEBRASKA  
PUBLIC SERVICE COMMISSION, ON ITS  
OWN MOTION, SEEKING TO ESTABLISH  
A LONG-TERM UNIVERSAL SERVICE  
FUNDING MECHANISM**

**APPLICATION NO. NUSF-26**

**DIRECT TESTIMONY OF  
BYRON WATSON**

**QWEST CORPORATION**

**March 4, 2002**

1   **IDENTIFICATION OF WITNESS**

2   **Q.     PLEASE STATE YOUR NAME, CURRENT POSITION, AND BUSINESS**  
3   **ADDRESS.**

4   **A.**     My name is Byron Watson. I am a Witness and Advocacy Manager for Qwest  
5   Services Corporation ("Qwest"), located at 1801 California Street, Denver, Colorado  
6   80202.

7   **Q.     PLEASE DESCRIBE YOUR WORK EXPERIENCE.**

8   **A.**     I have been employed by Qwest or its predecessor, U S WEST, for the past five  
9   years. My responsibilities have involved cost development and modeling, as well as  
10   universal service fund advocacy. Prior to working for Qwest, I have been employed in a  
11   variety of financial and technical roles that also involved assigning economic costs and  
12   modeling complex systems.

13   **Q.     PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND**  
14   **OTHER QUALIFICATIONS.**

15   **A.**     In 1989, I received a Bachelor of Science degree in Electrical Engineering from  
16   Southern Methodist University in Dallas, with an emphasis in telecommunications. In  
17   1991, I received a Master of Business Administration from Emory University in Atlanta  
18   with an emphasis in finance.

19   **Q.     WHAT ARE YOUR CURRENT JOB RESPONSIBILITIES?**

20   **A.**     My current responsibilities include the analysis of forward looking economic cost  
21   models, and the development of advocacy as to their accuracy and usefulness. Also, I  
22   provide economic advocacy regarding the design of high cost funds

1   **Q.    HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE NEBRASKA**  
2   **PUBLIC UTILITY COMMISSION?**

3   **A.    No, but I have testified and / or participated in universal service proceedings in**  
4   other states, including Colorado, Idaho, Iowa, Oregon, and Utah.

5  
6   **II.    PURPOSE OF TESTIMONY AND SUMMARY**

7   **Q.    WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

8   **A.    The purpose of my testimony of my testimony is to address issues raised by the**  
9   Nebraska Public Service Commission's ("the Commission") in its January 28, 2002 Pre-  
10   hearing Conference Order and Order Setting Hearing.  Specifically, my testimony  
11   addresses the issues of cost determination and fund structure in the third issue.

12   **Q.    PLEASE SUMMARIZE YOUR TESTIMONY.**

13   **A.    In a competitive marketplace, implicit subsidies cannot survive.  Unless implicit**  
14   subsidies are replaced with explicit support, competitors will take advantage of an  
15   Incumbent Local Exchange Carrier's ("ILEC") artificially high prices for certain  
16   regulated services.  Ultimately, the ILEC's ability to serve its rural and residential  
17   customers will be crippled.

18       A sufficient fund enables an ILEC to continue to serve its rural and residential  
19   customers at affordable rates.  Also a sufficient fund encourages fair competition for all  
20   services and throughout all regions of Nebraska.

21       Qwest recommends that the size of the high cost fund be based on the difference  
22   between economic cost and an appropriate benchmark.  Economic cost is best estimated  
23   by a cost proxy model.

24

1    **III.    NEBRASKA UNIVERSAL SERVICE FUND STRUCTURE**

2    **Q.    WHAT IS THE PURPOSE OF A HIGH COST FUND?**

3    **A.**    As the Commission has noted, implicit subsidies from services such as toll and  
4    business have, in the past, been used to keep residential rates affordable.<sup>1</sup> However, in a  
5    competitive marketplace, these implicit subsidies will be erased because competitors,  
6    who can charge market rates, will undercut an ILEC's artificially higher rates. This form  
7    of uneconomic competition is sometimes referred to as "cream skimming," or  
8    "arbitrage." Likewise, competitors will not offer products that receive implicit support,  
9    because the ILEC's rates for such products are below cost.

10          The purpose of a high cost fund is to preserve and advance universal access to the  
11    public switched phone network by replacing implicit subsidies with explicit and  
12    sufficient support so that high cost customers can continue to enjoy affordable service  
13    throughout Nebraska. A secondary goal is to create a "level playing field" where  
14    competition is robust for both residential and business customers whether they are rural  
15    or urban.

16    **Q.    HAS THE COMMISSION CREATED A FRAMEWORK TO ELIMINATE**  
17    **IMPLICIT SUBSIDIES?**

18    **A.**    Yes, on January 13, 1999, the Commission issued a Findings and Conclusions  
19    order in Application C-1628 ("the Order"). In it, The Commission resolved the major  
20    issues on how to structure the Nebraska Universal Service Fund ("NUSF").

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1 See Findings and Conclusions Order, Application No. C-1628, Entered 1-13-1998,  
page 2

1           The Order established a transition fund which is being replaced by a permanent  
2 one in this proceeding. The basic conclusions of the Commission remain valid and  
3 relevant to this proceeding.

4   **Q.     SHOULD THE ORDER'S FINDINGS APPLY TO RURAL ILECs?**

5   **A.     Yes.** For the NUSF to be portable and competitively neutral rural ILECs should  
6 receive the same treatment as non-rural ILECs.

7   **Q.     WHY SHOULD RURAL ILECs RECEIVE THE SAME TREATMENT AS**  
8 **NON-RURAL ILECs?**

9   **A.     In order to fulfill the Commission's mandate to promote universal access to basic**  
10 services at reasonable rates, sufficient support need only consider costs that would be  
11 incurred by an efficient provider. Subsidizing costs caused by inefficiencies is not  
12 necessary and encourages inefficient investments not related to providing basic local  
13 service. This is because, once economically sufficient support is in place to ensure  
14 universal access, no additional support should be required to assure available and  
15 affordable service. For these reasons, there is no reason to afford any class of carrier any  
16 special consideration.

17

#### 18   **IV.    FUND CALCULATION**

19   **Q.     WHAT IS A SUFFICIENT FUND SIZE?**

20   **A.     A sufficient fund in Nebraska allows Eligible Telecommunications Carriers**  
21 **("ETCs") to replace implicit support with explicit support and thereby lower regulated**  
22 **rates that are above economic cost downward toward economic cost. In that way, the**  
23 **ETC is no longer forced to offer services at an uncompetitive high rate which is then**

1 open to “cream skimming.” If the fund is too small, ETCs will eventually see their  
2 implicit support “skimmed” away, which will impair their ability to provide universal  
3 access.

4 On the other hand, if a fund is too large, an ETC may be compensated for selling  
5 other services below their economic cost, which is unnecessary and overly burdens  
6 Nebraska rate payers.

7 **Q. WHAT DO YOU MEAN BY ECONOMIC COST?**

8 **A.** For the purpose of universal service, economic cost is the forward-looking cost  
9 faced by the least cost, most efficient, carrier to provide service. The purpose of a high  
10 cost fund is to ensure access to service at a reasonable rate, but not to ensure that any one  
11 carrier will provide that service. Therefore, economic cost means the minimum cost that  
12 would pay for the most efficient carrier to provide basic service to an area.

13 **Q. WHAT IS THE BEST WAY TO DETERMINE ECONOMIC COST?**

14 **A.** While no method is completely accurate, the best approximation of economic cost  
15 is to generate estimates using a cost proxy model. Models take into account the fact that  
16 costs increase as population density decreases while at the same time, they model the  
17 least cost forward looking network for a given area.

18 **Q. CAN COST MODELS WORK FOR RURAL CARRIERS?**

19 **A.** Yes, because the fact that a particular area is currently served by a smaller  
20 company has no bearing on the economic cost to serve that area. The greatest challenge  
21 to using cost proxy models for rural areas is the relative difficulty in obtaining accurate  
22 customer location data.

1           While it is likely that a rural carrier has fewer economies of scale than a non-rural  
2 carrier, on an ongoing basis, that fact is irrelevant in economic terms. A high cost fund is  
3 not a carrier-specific cost recovery mechanism, nor is this a rate setting proceeding. The  
4 purpose of this proceeding is to identify and replace an implicit subsidy with an explicit  
5 fund, without impacting any carrier's net revenues.

6           The amount of support should be sufficient to encourage at least one efficient  
7 provider to compete in each region of Nebraska. The fact that an ETC loses customers to  
8 competition is not, by itself, an indication that USF support is insufficient. In a  
9 competitive environment, no single company should be expected to hold 100% market  
10 share. Indeed, one indication of sufficient support is widespread competition across all  
11 regions and products.

12   **Q.   WHAT IS THE PROPER STANDARD FOR ESTIMATING THE**  
13 **ECONOMIES OF SCALE IN ECONOMIC COST?**

14   **A.**   The economies of scale assumed in virtually all cost models are based on the  
15 scorched node assumption, which assumes that all telecom plant is replaced at the same  
16 time by a single provider. Only the location of the central office is kept constant in this  
17 scenario which yields the least cost, most efficient network capable of serving all  
18 customers.

19           Under the scorched node scenario, even a small LEC would need to purchase  
20 substantial quantities of cable, structure, placement services, and circuit electronics to  
21 replace its entire network. These economies of scale reasonably imply substantial  
22 purchasing power.

1   **Q.    SHOULD THE COMMISSION ELECT TO NOT ACCEPT QWEST'S**  
2   **RECOMMENDATION TO USE A COST MODEL FOR RURAL ILECs, WHAT**  
3   **THEN DO YOU RECOMMEND?**

4   **A.**    If the Commission chooses not to adopt a cost proxy model for the rural ILECs, it  
5   should adhere, nonetheless, to the principles of economic cost. Excessive overhead  
6   should be disallowed, along with plant investments that are not currently employed to  
7   provide basic local service to customers in the ETC's regulated service area. This  
8   standard would disallow non-productive assets as well as assets used to overbuild other  
9   service areas.

10         Furthermore, if the Commission does not adopt a forward-looking cost model for  
11   the rural ILECs, it still could do so for the non-rural ILECs. The costs generated by the  
12   BCPM model in the Order remain a good determination of the economic cost to serve  
13   Qwest's high cost service areas and should be extended to the permanent fund.

14   **Q.    SHOULD THE COMMISSION CONSIDER AN EMBEDDED COST**  
15   **MODEL FOR DETERMINING HIGH COST SUPPORT?**

16   **A.**    Without reviewing a specific method of using embedded costs for the basis of a  
17   high cost model, Qwest can not state a position. There may be methods of using  
18   embedded costs that fairly estimate economic cost and the need for high cost support that  
19   satisfy both federal and state statutes. However, no such proposals have been introduced  
20   in this or other USF dockets in Nebraska.

21   **Q.    SHOULD THE COMMISSION CONSIDER DENSITY OR SCALE AS A**  
22   **METHOD FOR DETERMINING HIGH COST SUPPORT?**

1 A. Only a cost based mechanism will determine a sufficient and competitively  
2 neutral high cost fund that satisfies Nebraska statute 86-1404 (5). The BCPM model,  
3 accepted by the Commission in C-1628, does consider density and scale and  
4 appropriately applies them as drivers of economic cost.<sup>2</sup>

5 **Q. SHOULD THE COMMISSION ADOPT A REVENUE BENCHMARK?**

6 A. The Commission has asked interested parties to consider a revenue benchmark.  
7 Qwest advocates a benchmark based on affordability, not revenues.<sup>3</sup> If the Commission  
8 should consider a revenue benchmark, Qwest recommends that only regulated revenues  
9 directly related to providing supported basic local service be considered as part of this  
10 benchmark.<sup>4</sup>

11 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

12 A. Yes, it does.

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2 BCPM assumes the economies of scale implied by the Scorched Node scenario.

3 The purpose of a high cost fund is to shift revenues that comprise implicit subsidies to explicit support revenues. A revenue benchmark can easily become a rate case which asks whether total revenues are appropriate.

4 FCC's Seventh Report and Order, Para. 61 makes reference to the Second Recommend Decision, foot note 157: "we now believe, however, that the use of a revenue benchmark is becoming an administratively unworkable approach, given that carriers may now be bundling the supported services with services that are not provided on the supported network, such as long distance services, wireless, and Internet services."

1 Prepared and Submitted this 4<sup>th</sup> day of March, 2002.

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